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The Ghost of Milton Friedman

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"Inflation is always and everywhere a monetary phenomenon." So wrote the late Nobel Prize winning economist and inflation-obsessed, Milton Friedman, in his 1963 magnum opus, *A Monetary History of the United States*. And Friedman's contention is, of course, unassailable. Certainly, the more money sloshing around in an economy, the higher prices will rise. This logic in hand, the number-one concern we hear from clients these days is that the unprecedented expansion of the Federal Reserve's balance sheet (i.e., the money the Fed is injecting into the economy to cushion the effects of the financial meltdown) combined with exploding Federal budget deficits can only result in high inflation.

One of the first terms you'll hear in an undergraduate economics class is the Latin phrase, *ceteris paribus*. Loosely translated, it means "all else constant." Economists typically assume *ceteris paribus* when they explain how a change in one variable affects other variables. For instance, an economist might say that, *ceteris paribus*, rising prices for hamburger would cause lower consumer demand. And in theory that's correct. Unfortunately, in the real world "all else" rarely stays constant. For instance, if household incomes are rising even faster, household demand for hamburger could still increase despite its higher cost.

Similarly, assuming *ceteris paribus*, the enormously stimulative actions taken by the Federal Government and Federal Reserve in recent months are undoubtedly inflationary. But here again all else isn't constant. Several mitigating factors exist that should keep the ghost of Milton Friedman at bay for years to come.

Consider first the fundamental reason prices rise – demand exceeds supply. Today our problem is precisely the opposite. To wit, the Congressional Budget Office expects the output gap in the U.S. – the supply of goods and services we're capable of producing at full capacity minus current demand – to average about 7% of GDP over the next two years, or almost $1 trillion a year. Note that this estimate *includes* ballooning Federal Government spending without which the output gap would be even wider.

An unemployment rate approaching 10% and U.S. manufacturing capacity utilization below 70% – the lowest level since records began in 1967 – attest to the enormity of the current output gap. Such excess supply exists because, for at least a decade and arguably the past 25 years, ever-increasing debt levels artificially boosted the economy. Now, loan defaults have soared and our major financial institutions teeter on the cusp of insolvency. Households no longer have the capacity to borrow and even if they did, most financial institutions are in no position to lend. Demand for goods and services has therefore shrunk drastically, leaving behind a huge oversupply of everything from homes to office space to gas-guzzling SUVs.

So again we return to that stubborn law of supply and demand. As long as we have all that excess supply, most producers will find it extremely difficult to raise prices. How long do we have before demand catches back up? Economists at Goldman Sachs recently estimated that the U.S. economy would have to grow 4.75% a year through 2015 for the output gap to close. If we grow *just* 3.75% a year it'll take a decade.

The case for inflation, therefore, must rest on the idea that all the money the Federal Reserve is creating will soon work its way into the economy, spur torrid demand growth, and rapidly close the output gap. The trouble, however, is that while the Fed can increase the supply of the money, it can't force heavily indebted consumers to borrow more or damaged financial institutions to lend. Households and financial institutions will need time to pay down debt and repair their weak balance sheets. This adjustment to higher savings and lower debt levels is why an extended period of below-average GDP growth typically follows the bursting of a major credit bubble. Thus, much of the money the Fed has created should continue to languish in the coffers of financial institutions, accomplishing little in the way of stimulating demand.

But surely households and businesses will eventually start borrowing again and banks will start lending. And when that happens won't all the money the Fed creates today ultimately cause inflation? If the Fed was literally "printing" money and dropping it from helicopters (as current Fed Chairman Ben Bernanke once off-handedly suggested as an antidote to persistent deflation) the answer would be yes. But understand that the Federal Reserve is not printing currency but rather extending credit to banks, corporations, and the Federal Government. *This money will eventually be repaid*. As time passes the money supply will naturally shrink back to size.

The Fed's recent actions, therefore, differ starkly from those of governments that have inflicted hyper-inflation upon their citizens like the post WWI Weimar Republic (Germany) and more recently third-world nations like Zimbabwe. In those inflationary episodes, governments literally printed immense quantities of currency, which, once floating around their economies, couldn't be withdrawn.

The final worry of those expecting inflation is that China and other foreign central banks will cease financing our spending (by buying our bonds), precipitating a crash in the U.S. dollar. A plunging dollar would then cause import prices to skyrocket and inflationary pressures to surge. But upon closer examination these fears look overblown. For one thing, as the current economic crisis has progressed, total U.S. borrowing from abroad has actually declined sharply. The reason is that surging Federal Government borrowing has been more than offset by higher U.S. household saving rates and a dramatic decline in private sector investment. In other words, private sector borrowing has dropped at a faster rate than public sector borrowing has risen.

Further, the vast majority of goods and services consumed in America are still made in America. Specifically, just over 13% of what we buy today comes from overseas ($1.9 trillion in imports vs. $14.1 trillion in nominal GDP). Thus, a dollar crash of 50% would only imply a 13% increase in prices generally, and that rise would likely be spread out over several years.

But a dollar decline of that magnitude is highly improbable anyway. What would the dollar crash against? The Euro? The Yen? Europe and Japan have even bigger economic and demographic problems than we do. And it would be tantamount to economic suicide if China allowed the dollar to crash relative to its currency, the Yuan, as China is as dependent on us as we are on them. If the Yuan doubled overnight relative to the U.S. dollar, China's exporting industries – the foundation of their entire economy – would collapse, as their products would be twice as expensive so Americans would buy significantly less. Tens of millions of Chinese workers would lose their jobs, and civil unrest would be a serious threat. Thus, the Chinese can no more stop buying U.S. Treasuries than we can stop issuing them to finance our deficits. As the director general at the China Banking Regulatory Commission, Luo Ping, resignedly commented this past February (reported by the Financial Times),

"Except for U.S. Treasuries, what can you hold? Gold? You don't hold Japanese government bonds or U.K. bonds. U.S. Treasuries are the safe haven. For everyone, including China, it is the only option….We hate you guys but there is nothing we can do."

Extreme predictions make good headlines but rarely prove accurate. In most cases, and like most of life, the reality lies somewhere in the middle. So on one side we have those who proclaim that the actions taken by the Federal Reserve and Federal Government will lead to hyperinflation and a worthless currency. On the other side are those who believe – just as fervently – that the bursting of the credit bubble will lead us down a path similar to the Great Depression where massive deflation (because supply so greatly exceeded demand) was the order of the day.

But from our perch the most likely scenario is that the deflationary pressures of the credit meltdown will more or less offset the inflationary pressures of current monetary and fiscal policy. In other words – and though admittedly not a terribly exciting prediction – we expect prices overall to remain relatively stable.